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October 23, 2002

VIA ELECTRONIC FILING
Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th St., SW, Room TWB-204
Washington, DC 20554

> Re: Application of Bellsouth for Authorization to Provide In-Region,
> InterLATA Services in Florida and Tennessee
> WC Docket No. 02-307

Dear Ms. Dortch,

The attached testimony was sent to Josh Swift of the Wireline Competition Bureau at his request on October 22, 2002. Please include a copy in the record of the referenced proceeding.

One electronic copy of this Notice is being submitted to the Secretary of the FCC in accordance with Section 1.1206 of the Commission's rules.

Sincerely,

Jodi S. Sirotnak

Attachments
cc: Josh Swift
       Christine Newcomb
       Luin Fitch

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY OF

JOHN C. DONOVAN

AND

BRIAN F. PITKIN

ON BEHALF OF

AT&T COMMUNICATIONS OF THE SOUTHERN STATES, INC. and

MCI WORLDCOM, INC.

Docket No. 990649-TP

July 31, 2000

PUBLIC VERSION

1

1 *BellSouth's inputs improperly double-count inflation*

2 Q. HOW DO BELLSOUTH'S CALCULATIONS OF LOOP COSTS

3 IMPROPERLY DOUBLE COUNT THE EFFECTS OF

4 INFLATION?

5 A. The cost of capital employed by BellSouth, this Commission, and Mr.

6 Hirshleifer are "nominal" costs of capital. Nominal costs of capital

7 compensate investors not only for the time value of money and business

8 and financial risk, but also for the effects of inflation. BellSouth's

9 proposed prices double-count inflation by:

10 • Using a unit-cost inflation factor that is applied to the material
11 investment generated by the BSTLM; and

12 • Updating the unit costs for material and labor from what was
13 previously determined by this Commission.

14 Q. WHY DOES USE OF THE INFLATION FACTOR BY

15 BELLSOUTH DOUBLE COUNT THE EFFECTS OF INFLATION?

16 A. The cost of capital that Mr. Hirshleifer has developed, which we included

17 in our restatement of the BellSouth models, already accounts for the

18 effects of inflation. Specifically, the costs of debt and equity that Mr.

19 Hirshleifer developed from financial market data already include a

20 component that compensates ILEC investors for the loss in purchasing

21 power of their invested capital that would otherwise be caused by the

22 effects of inflation (thus, Mr. Hirshleifer developed a nominal cost of

23 capital as opposed to a "real" cost of capital, which is the nominal cost of

24 capital minus the rate of future inflation anticipated by debt and equity

17

1   investors). Furthermore, the cost of capital previously adopted by the

2   Florida PSC in its prior proceedings was also a nominal cost of capital,

3   meaning it was high enough to compensate ILECs for the effects of

4   inflation. Any other adjustment for inflation, outside of the cost of capital,

5   includes the effects of inflation *twice* in the capital component of the cost-

6   based prices that BellSouth proposes.

7   Q.   WHY DOES BELLSOUTH'S UPDATING OF THE MATERIAL

8   AND LABOR COSTS, FROM WHAT HAS BEEN PREVIOUSLY

9   DETERMINED BY THIS COMMISSION, DOUBLE COUNT THE

10   EFFECTS OF INFLATION?

11 A.   We understand that the capital cost components of the various annual

12   recurring costs previously adopted by this Commission in the UNE and

13   USF cases were developed by applying a nominal cost of capital to the

14   forward-looking investment. Thus, these costs were high enough to offset

15   the future effects of inflation. Allowing BellSouth to adjust the unit prices

16   and labor rates it uses to develop investments in this proceeding

17   effectively compensates the ILECs *twice* for the effects of inflation, once

18   as part of the nominal cost of capital and again by inflating the investment

19   base to which the nominal cost of capital is applied.

1	Q.	WHY DO THE PARTIES RELY ON NOMINAL COSTS OF
2		CAPITAL (ONES THAT INCLUDE COMPENSATION FOR
3		INFLATION) RATHER THAN REAL COSTS OF CAPITAL (ONES
4		THAT DO NOT INCLUDE COMPENSATION FOR INFLATION)?
5	A.	Use of the nominal cost of capital is the most straightforward approach,
6		because (as Mr. Hirshleifer discusses in his testimony) nominal costs of
7		capital can be derived directly from data observable in financial markets.
8		But if nominal costs of capital are employed, unit prices for material and
9		labor used to develop the total network investment must be locked in at
10		the levels initially established by the Commission. An alternative is to
11		apply the real cost of capital to investment levels that are allowed to
12		increase with inflation. While conceptually more consistent with the
13		competitive market standard, such an approach is more unwieldy because
14		it would require the Commission to estimate a real cost of capital. In
15		addition, this approach would require that UNE rates increase each year to
16		reflect the effects of inflation on the underlying investments. What clearly
17		is inappropriate is to apply the <u>nominal</u> cost of capital to network
18		investment levels that <u>also are allowed to increase</u> to reflect the effects of
19		inflation because, as we stated above, BellSouth would thereby be
20		compensated *twice* for the effects of inflation.

19

| 1 | Q. | CAN YOU PROVIDE A SIMPLE EXAMPLE OF THESE TWO |
| 2 | | ALTERNATIVE METHODS OF CAPITAL RECOVERY? |

3 A. Consider an example with an initial investment of $1,000,000 employing

4 the following assumptions:

- Economic life is 10 years;
- Nominal cost of capital is 10%;
- Inflation rate is 4%;
- Real cost of capital is 5.77% (1.10 / 1.04 - 1).

These assumptions lead to the following two cost recovery patterns that,
over the life of an asset, have a present value equal to the initial
investment in the asset. Exhibit JCD/BFP-4 illustrates that calculating an
annuity based on the nominal cost of capital fully recovers the initial
$1,000,000 investment over the 10-year period. The exhibit also
illustrates that calculating an annuity based on the real cost of capital, and
then inflating the annuity each year at the appropriate inflation rate
similarly fully recovers the initial $1,000,000 investment over the 10-year
period. Under either approach, the nominal discount rate is appropriate
because the cash flows being discounted (shown in the "Inflated Annuity"
column) already reflect the effects of inflation. Exhibit JCD/BFP-5
illustrates these two recovery pattern. The above charts help to illustrate
the point that both cost recovery patterns result in the same present value
at the end of the asset's life. However, it is obvious that using the nominal
cost of capital allows BellSouth to recover more of its initial investment

20

1   earlier in the asset's life than using the real cost of capital. Therefore, if

2   BellSouth is allowed to submit new material and labor prices before year

3   10, say in year 5, BellSouth will have over-recovered the appropriate

4   amount of investment over this time period.

5   The inflation double-count in BellSouth's approach is illustrated in the

6   example in Exhibit JCD/BFP-6, which assumes that BellSouth uses a

7   nominal cost of capital and seeks new UNE rates each year to reflect the

8   effects of inflation on asset and labor unit prices.

9   Exhibit JCD/BFP-6 shows that under BellSouth's approach, it would over-

10 recover its initial investment by more than 21 percent if it were allowed to

11 use the nominal cost of capital and adjust the material and labor prices for

12 the effects of inflation. The charts in Exhibit JCD-BFP-7 also help to

13 illustrate this point.

14 The solid lines on the charts in Exhibit JCD/BFP-7 are both sufficient to

15 allow BellSouth to recover its investment and earn its cost of capital.

16 Thus, the charts show that BellSouth's proposed approach, represented by

17 the dashed lines, would allow it to recover more than the true economic

18 cost of the asset. The difference between the two sets of lines on each of

19 the above graphs illustrates the amount of BellSouth's over-recovery in

20 each year, under the assumptions we have employed, if BellSouth is

21 allowed both to use a nominal cost of capital and to inflate the underlying

22 unit prices.

21

1	Q.	WHAT ARE THE IMPLICATIONS OF THIS DISCUSSION FOR
2		THE COST CALCULATIONS THAT THE COMMISSION MUST
3		MAKE IN THIS PROCEEDING?
4	A.	The Commission must calculate the capital component of recurring costs

in a manner that avoids compensating BellSouth twice for inflation. As noted above, this can be done either (1) by using the previously-adopted material unit prices and labor rates in establishing the total network investment, and applying the appropriate nominal cost of capital, or (2) by using current material unit prices and labor rates and applying the real cost of capital (which also then requires that UNE rates be adjusted in subsequent years to reflect the effects of inflation on underlying material and labor unit prices). Because real costs of capital are difficult to calculate with precision, and because the UNE prices that have been in effect the past several years were based on a nominal cost of capital, we would recommend that the Commission continue to calculate the capital component of recurring costs by employing a nominal cost of capital and that it "lock in" its previously-adopted material unit prices and labor rates. This Commission's USF decision similarly recognized that "indexing may be appropriate, for example, in a contract arbitration, but not in this proceeding." (Order No. 980696-TP, pg. 157) Indexing is similarly not appropriate in this proceeding.

22

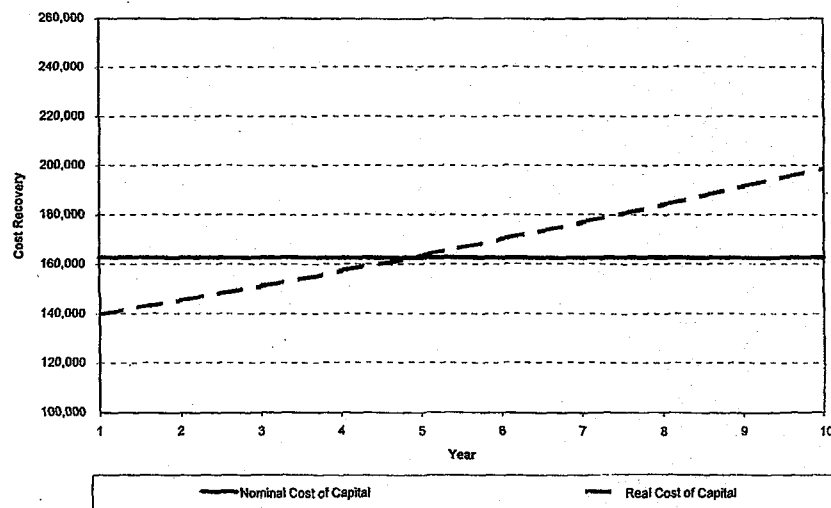| 1 | Q. | WHICH MATERIAL AND UNIT PRICES THAT THIS |
2		COMMISSION HAS PREVIOUSLY ADOPTED DO YOU
3		RECOMMEND?
4	A.	We recommend that this Commission rely on the material and unit prices
5		it adopted in the USF proceeding, Docket No. 980696-TP.
6	Q.	WHY DO YOU RECOMMEND USING THE COMMISSION'S
7		DECISION IN THE USF PROCEEDING?
8	A.	This USF decision specified the inputs appropriate for BellSouth in the
9		sBCPM. There are three primary reasons why we feel it is appropriate to
10		employ these unit-cost inputs to modify the BSTLM:

- 11/12/13/14 Both the BCPM and the BSTLM purport to estimate the forward-looking cost of providing UNEs using current technologies, so the theoretical frameworks for the two cost proxy models should be similar;

- 15/16/17 Many of the inputs in the BSTLM are similar or directly equivalent (except for DLC equipment which we describe below) to the inputs used in the BCPM, so the inputs are easily transferable; and

- 18/19/20 BellSouth sponsored the BCPM in the Universal Service docket and the Commission's decisions considered BellSouth's evidence on inputs in that docket.

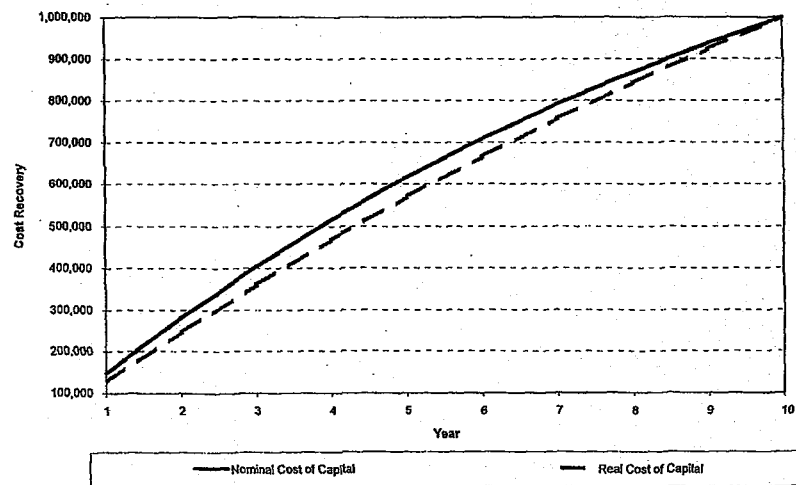| 21 | | For these reasons, we believe that these inputs can be used in the BSTLM |
| 22 | | without the need to re-litigate unit cost inputs that this Commission has |
| 23 | | already adopted. |

Year	Nominal Cost of Capital					Real Cost of Capital				
	Annuity	Inflation Factor	Inflated Annuity	Present Value Factor	PV of Annuity	Annuity	Inflation Factor	Inflated Annuity	Present Value Factor	PV of Annuity
1	$162,745	N/A	$162,745	0.9091	$147,950	$134,386	1.0400	$139,762	0.9091	$127,056
2	162,745	N/A	162,745	0.8264	134,500	134,386	1.0816	145,352	0.8264	120,126
3	162,745	N/A	162,745	0.7513	122,273	134,386	1.1249	151,166	0.7513	113,574
4	162,745	N/A	162,745	0.6830	111,157	134,386	1.1699	157,245	0.6830	107,379
5	162,745	N/A	162,745	0.6209	101,052	134,386	1.2167	163,502	0.6209	101,522
6	162,745	N/A	162,745	0.5645	91,866	134,386	1.2653	170,042	0.5645	95,967
7	162,745	N/A	162,745	0.5132	83,514	134,386	1.3159	176,843	0.5132	90,749
8	162,745	N/A	162,745	0.4665	75,922	134,386	1.3686	183,917	0.4665	85,799
9	162,745	N/A	162,745	0.4241	69,020	134,386	1.4233	191,274	0.4241	81,119
10	162,745	N/A	162,745	0.3855	62,745	134,386	1.4802	198,925	0.3855	76,694
TOTAL					$1,000,000					$1,000,000

Annuity

Chart with Y-axis labeled "Cost Recovery" ranging from 100,000 to 260,000, and X-axis labeled "Year" ranging from 1 to 10. Legend: Nominal Cost of Capital (solid line), Real Cost of Capital (dashed line).

Cumulative Present Value of Annuity

Legend: —— Nominal Cost of Capital —— Real Cost of Capital

1

Annuity

Chart titled "Annuity" with x-axis labeled "Year" (1 to 10) and y-axis labeled "Cost Recovery" (100,000 to 260,000). Legend: solid line "Nominal Cost of Capital", dashed line "Nominal Cost of Capital Plus Inflation".

Annuity

Year

— Loan Cost of Credit
- - Residual Cost of Capital Plus Inflation

$280,000
$260,000
$240,000
$220,000
$200,000
$180,000
$160,000
$140,000
$120,000
$100,000